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BASIC White Paper

IRS Section 125:
Flexible Spending Accounts

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FSA: Flexible Spending Accounts – What employers need to know

What is an FSA?

A flexible spending account (FSA) is an employer sponsored benefit that allows employees to set aside money on a pre-tax basis for qualified medical, dental, vision and/or child care expenses. By electing to contribute to an FSA, employees can save between 15%-40%. By offering this benefit, employers save 7.65% (the combined Social Security and Medicare tax rate) on the value of contributions to the FSA.

There are three types of FSAs:

1. **Health FSAs** are used to pay health expenses such as insurance deductibles, co-payments, coinsurance, and prescription, dental, and vision expenses for the employee, spouses and dependent children.
2. **Dependent Care FSAs** (also called a DCAP) are used to pay for dependent child care expenses while the legal guardians are at work or school. DCAPs are most often used to pay child care expenses for children under the age of 13. However, they are also available to pay expenses for adult dependents who are physically or mentally incapable of caring for themselves and who have the same principal place of abode as the employee for more than half of the year.
3. **Limited Purpose FSAs** are designed to work in conjunction with Health Savings Accounts (HSAs). Employees who elect a Limited Purpose FSA can pay for dental and vision expenses with their pre-tax contributions and remain eligible to make HSA contributions. This benefit design helps employees save money while retaining their HSA eligibility.

How are FSAs provided to Employees?

Because FSAs are generally funded by employees through pre-tax salary reductions, they are offered by employers as part of a cafeteria plan under Section 125 of the Internal Revenue Code (Section 125 Plan). A Section 125 plan is the only means by which an employee is permitted to use pre-tax dollars to contribute towards employer sponsored benefits (e.g. health insurance premiums, dental or vision premiums, disability premiums, life insurance, and FSA accounts).

To take advantage of the tax savings for employers and employees associated with an FSA under a Section 125 Plan, employers must adopt a written plan document. If employees contribute towards other employer sponsored benefits and the employer has already adopted a Section 125 Plan, FSA provisions may be added to the existing document. The plan document must specifically include the following:

- A description of all benefits
- Manner of contributions
- Maximum amount of contributions
- Rules regarding eligibility and elections
- Plan Year and any grace period or carryover provisions
- Uniform coverage rule

With a plan document in place, employers can self-administer the FSA benefit, but the majority of employers choose to work with a third party administrator to process reimbursement claims and assist with compliance.

FSA Issues to Keep in Mind

- Each benefit offered under a Section 125 Plan is subject to maximum contribution limits under the Internal Revenue Code. You can view the current limits on our regulation webpage. Employers are permitted to set maximum contributions below the IRS allowable rate.
- Only specific types of expenses may be reimbursed under an FSA. Third party administrators are well versed in these issues.
- Section 125 Plans should be evaluated under the nondiscrimination rules specific to cafeteria plans. Additional testing is required for health FSAs and DCAPs.
- Health FSAs are subject to ERISA. Therefore, additional documentation and operational compliance is required for proper administration.
- FSAs are subject to a "use-or-lose" rule. This means that if the employee does not spend all the funds available in his or her FSA during the plan year, the employee forfeits any unspent funds unless the FSA includes a grace period or carryover as follows:
    - Employers may allow a "grace period" of up to two- and one-half months after the end of the plan year to use funds in an FSA. Claims may be submitted for expenses incurred during the plan year and during the grace period. Grace periods are permissible for all types of FSAs.
    - Health FSAs may allow a grace period or a carryover. The carryover allows participants to rollover $500 from one plan year to the next. The $500 is not calculated into the IRS maximum contribution
- Under the uniform coverage rule, health FSAs are fully funded at the beginning of the plan year. If an employee's reimbursements outpace the contributions made and the employee terminates employment before the end of the plan year, the employer is not permitted to deduct extra funds to catch up the contributions from final paychecks.
- Employers determine the FSA plan year. They generally choose to mirror their group health plan year or fiscal year.